C.D. Howe Institute

Commentary

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PAYING BY THE INSTALLMENT PLAN: ANALYSIS OF THE FEBRUARY 26 FEDERAL BUDGET

Summary: The February 26, 1986, federal budget presented Canadians with a credible fiscal plan to slow the rate of accumulation of federal debt. Its main message was that as long as Canadians regard deficits as "the government's problem" and resist spending reforms, their taxes will have to be raised to pay more of the cost of public programs. The most significant issues are post-budget ones. First, Canada must avoid a conflict between monetary and fiscal policy. Second, the federal government must live up to major budget commitments to hold the line on nonstatutory spending and to reform tax and spending programs, even though it is in the third year of its political mandate.

The February 26, 1986, federal budget presented Canadians with a credible fiscal plan. Where the Progressive Conservative government's first two fiscal actions succeeded only in containing the growth of the federal budget deficit, this budget began in earnest the installment payments that will reduce the deficit and significantly slow the buildup of public debt.

In the first few days of its life, however, the budget's credibility was a major issue, particularly in the financial community. It was argued that the government had done too little too late; that errors in underlying assumptions had understated the risks to the budget's deficit forecasts; and that the government had gone about reducing the deficit the wrong way.

Yet those who have these concerns risk not being able to see the forest for the trees. While such important issues must be part of the evaluation of the budget's soundness, they are issues about the means by which the government intends to carry out its deficit-reduction strategy, not the end that is sought. The more important issue is to present a credible plan to restore fiscal stability by slowing the growth of the public debt. We believe the government has succeeded. But it has created problems for itself by overselling its version of what the budget will accomplish and how to do it.

In this **Commentary**, we examine these issues, reviewing, first, the budget's political and economic context; second, its major features; and third -- and most importantly -- the post-budget issues. In a fiscal plan that is based on installment payments, the preparation of the next installment must begin immediately.

The Budget's Context

The context of the February budget would be incomplete if it focused only on economic factors. Indeed, the government faced a series of tough tradeoffs between political and economic constraints. There has been public criticism of some

of the tradeoffs that it made.

The main political constraint was Canadians' reluctance to face up to the significance of persistent deficits and the tough choices they will have to make to bring down these deficits. During the consultative process of the past 18 months, we have seen many special-interest groups express support for the status quo. Many Canadians have viewed the deficit as the government's problem; they have expressed the conflicting beliefs that we should not have to tighten our belts and take less from government, and that we should not have to pay more to cover the cost of government benefits and programs either. Those beliefs simply do not square with the reality that the resulting public-sector borrowing has to be managed and reduced.

In this context, the government's choice of budget measures was further constrained in familiar ways: the burden of restraint had to be spread as fairly as possible; and the best possible use of deficit-reduction options had to be made in the absence of a strategy for dealing with statutory spending, which accounts for just under 60 percent of all spending on federal programs.

Paradoxically, economic dynamism provided a second constraint. The overall economic environment was markedly improved in performance and expectations over that for the two previous budgets. In the past year, Canada has had a dose of the best economic news in a decade. Inflation continues to decline, while growth momentum has been sufficient to reduce the unemployment rate below 10 percent for the first time in four years. Taking only short-term performance into account, many Canadians tended to be complacent about the risks posed by the government's rapidly accumulating indebtedness.

A third constraint was the abrupt changes in the international environment at the end of 1985. Falling world oil prices added to problems already created by four years of weak commodity prices. The sudden drop in the value of the Canadian dollar in North American foreign-exchange markets created major uncertainties about the cause and about possible corrective action.

Much of the credibility of the government's fiscal plan rested on budget-makers' assumptions about the prospects for economic growth, volatile oil prices, and interest rates. The budget assumed world oil prices will be higher and interest rates will be lower during the next two years than the predictions of most other analysts.

Lower-than-anticipated oil prices present problems because of their mixed economic implications for the Canadian economy. Lower oil prices will adversely affect oil exploration and development prospects in Western Canada and reduce sharply the rate of energy-related investment by Canadians and foreigners. Offsetting the impact on business investment, however, are the positive effects of lower oil prices on consumers. These act like a tax cut, which might well offset the effects of the budget's tax increases during the next two years. The positive impact also can be expected to be felt by downstream activities such as refining and petrochemicals, by other producers that rely on petroleum products as energy sources, by the transportation industry, and by homeowners and motorists.

This mixed picture can be expected to have two main implications for policy. The first is for budgetary revenue projections. Initially, oil-based tax revenues will decline. But growth-based tax revenues will rise because of the stimulative effect of lower oil prices. While stimulative effects likely will dominate in the medium term, the first-year effect may be to increase the deficit temporarily.

The second implication is for interest rates and the exchange rate. Reduced investment prospects are likely to be reflected in lower demand for the Canadian dollar and in a weaker, trade-weighted exchange rate. The validity of the budget's interest-rate projections will depend on the Bank of Canada's diagnosis of

the causes of the dollar's weakness, and on the weight it attaches to inflationary concerns associated with exchange-rate depreciation compared with growth concerns associated with higher interest rates.

The February 26 Budget

The picture that emerges from the February 26 budget is clear. The government moved decisively to control its finances so that by the end of the decade, the accumulation of public debt will decline to a rate similar to that of the economy's growth.

The government chose in this budget to reduce its borrowing requirements by emphasizing tax-rate increases and by focusing spending cuts on nonstatutory programs. In adopting this strategy, the government stressed two important factors, which some observers have found dubious. First, Finance Minister Wilson portrayed this budget as the third in a multistage fiscal strategy. Taking the past three fiscal actions together, the minister argued that spending cuts, not tax increases, are the main source of deficit reduction.

Second, the budget speech made very clear commitments to longer-term strategic reforms: in corporate taxation, in sales taxation, and in the personal income tax and transfer system. If these commitments are carried out, it is possible to see how the surtaxes imposed in this budget might be temporary ones after all.

Our assessment of the budget, which follows, focuses on:

- the accumulation of federal debt;
- the credibility of expenditure changes; and
- the impact of tax changes.

The Accumulation of Federal Debt

Any prudent fiscal plan must avoid an ever-rising debt-to-GNP ratio because of the impact of rising debt charges on budgetary expenditures. By the time of the February 1986 budget, federal public debt had doubled to $233 billion in just over three years. The combination of measures announced in November 1984 and May 1985 had merely contained the growth of annual deficits; $35-40 billion still would be added to the debt each year to the end of the decade.

The February budget's fiscal plan would stabilize the debt-to-GNP ratio at somewhat less than 60 percent by fiscal 1991. (We use "fiscal 1991" to refer to the government's fiscal year, which ends on March 31 -- that is, the period from April 1, 1990, to March 31, 1991.) This projection is based on assumptions for moderate economic performance: that U.S. budget and trade deficits improve, that real interest rates subside but remain above historical levels, and that real economic growth averages slightly less than 3 percent annually. Faster growth, lower real interest rates, and larger reductions in U.S. deficits would see the ratio begin to decline as early as fiscal 1988. In this favorable scenario, Canada could have a balanced budget by fiscal 1991.

But the budgetmakers' task is not complete until they have secured the fiscal plan against the downside risks. In an unfavorable economic environment of slower growth and higher interest rates, the fiscal plan would still be hostage to spiraling debt-service charges; the debt-to-GNP ratio would increase steadily beyond 60 percent. This is why the February budget must be seen only as one step. Further steps are required to ensure control is firmly reestablished should the environment become unfavorable. Once that goal has been achieved, room for fiscal maneuver will exist once again.

The Credibility of Expenditure Cuts

The issue of how the deficit is cut assumes greater importance as spending cuts and tax increases come into effect. While the measures in the February budget

have improved the credibility of the government's deficit-reduction plan, the same cannot be said for the credibility of its claims that most of the cuts are on the spending side of the budget.

The expenditure changes, which amount to a net reduction of $670 million in fiscal 1987, have drawn a great deal of criticism, on two grounds. First, they were too small. Second, the eleventh-hour decision to cut $500 million from nonstatutory spending left the government with insufficient time to specify where the cuts would be achieved. This lack of specific details has created understandable skepticism about the government's commitment to make cuts.

The government has countered these criticisms by arguing that the measures adopted in November 1984, May 1985, and February 1986 will mean that, of the cumulative deficit reduction of $98 billion by fiscal 1991, 70 percent will come from spending cuts and 30 percent from tax increases. Yet, virtually every immediate post-budget analysis expressed disappointment at the government's continued caution on expenditure cuts. What explains this gap in perception?

Table 1 presents the government's calculation of how actions taken since November 1984 have contributed to deficit reduction in fiscal 1986 and 1987. This calculation focuses entirely on "discretionary" changes in spending and revenue -- that is, changes announced in fiscal statements or budgets that reduce spending or raise revenue compared to what they otherwise would have been. The benchmark for what spending and revenues would have been is a status-quo projection that was published as part of the November 1984 Economic Statement. The government's deficit-reduction estimates measure how its discretionary actions and the resulting reduction in debt-interest payments have altered the status quo. They do not, however, explain how the actual deficit is being reduced, for two reasons. The first is that they do not include such unanticipated developments as the failure of two western Canadian banks in 1985 or the payment of various

TABLE 1

Composition of "Discretionary" Deficit Reduction, fiscal 1986 and 1987

	Fiscal 1986		Fiscal 1987	
	$ billion	percent	$ billion	percent
Discretionary spending cuts	4.3	91.5	5.8	56.9
Discretionary tax increases	0.1	2.1	3.4	33.3
Imputed reduction in public debt interest[a]	0.3	6.4	1.0	9.8
Total deficit reduction	4.7	100.0	10.2	100.0

[a]Reduction in debt-interest payments resulting from discretionary spending cuts and tax increases.

Source: Department of Finance, The Fiscal Plan (Ottawa: February 1986), pp. 4-5.

industrial subsidies and grants. The second reason is that they do not reflect changes in spending and revenue that arise from such economic factors as stronger growth rates or higher interest rates than were originally assumed in preparing the status-quo projection.

Table 2 summarizes the contribution of actual -- rather than discretionary -- changes in spending and revenue to deficit reduction. It indicates much smaller deficit reduction in both fiscal years than do the government's figures, which focus only on discretionary changes. For example, while discretionary spending cuts and tax increases will reduce the fiscal 1987 deficit by $10.2 billion compared with what it otherwise would have been, the actual deficit will decline by only $4.6 billion. The reason for this discrepancy is that discretionary spending cuts are almost entirely offset by unanticipated spending increases. The combined effect of these unanticipated spending increases and higher-than-expected debt-interest payments is that total government spending likely will be only $0.5 billion lower in fiscal 1987 than was anticipated in the status-quo projection. Total revenues, however, are expected to be $4.2 billion higher and to account for almost 90 percent of the actual deficit reduction.

TABLE 2

Composition of Actual Deficit Reduction, fiscal 1986 and 1987

	Fiscal 1986		Fiscal 1987	
	$ billion	percent	$ billion	percent
Spending cuts	2.9	93.5	1.9	41.3
Tax increases	0.3	9.7	4.2	89.1
Public debt interest	-0.1	-3.2	-1.4	-30.4
Total deficit reduction	3.1	100.0	4.6	100.0

Sources: C.D. Howe Institute, based on data from Department of Finance, A New Direction for Canada (Ottawa: November, 1984); and idem, The Fiscal Plan (Ottawa: February, 1986).

A more accurate portrayal of fiscal actions is that while discretionary tax increases raise federal revenues, discretionary spending cuts merely make room for increased spending in other areas. For example, cuts in nonstatutory spending items in departmental budgets made it possible to finance bank failures, higher-than-expected debt-interest costs, and questionable industrial subsidies without raising the deficit. The job of reducing the actual deficit has been left primarily to higher taxes.

The picture does have a bright side, however, which has been overlooked in much public discussion. The government has held the line on total spending. Management in government has improved; in the past, unanticipated spending increases merely led to higher deficits. As a proportion of GNP, program expenditures drop from 19 percent in fiscal 1986, to 18 percent in fiscal 1987, and below this level in fiscal 1988.

At the same time, this achievement should not be oversold, as the government has done, by focusing only on its discretionary actions. By failing to focus attention on unanticipated increases in spending, the government has reduced the credibility of its deficit-reduction strategy. It has missed a strategic opportunity to warn Canadians of the continuing risk of rising debt-servicing costs associated with the huge and escalating federal debt. It has failed to make clear to Canadians that, in spite of its commitment to deficit reduction, it continues to face pressures both from within the Cabinet and from the general public to spend more.

The Institute's examination of the February budget, in the context of the consultation process of the past 18 months, leads us to conclude that the spending cuts in this budget were heavily constrained by the belief Canadians mistakenly hold that the deficit is the government's problem. Interest groups have proclaimed loudly their opposition to cuts in statutory programs. Canadians still have not debated the choices for reconciling the realities of deficit reduction with widely supported objectives of social programs.

This left the government with few alternatives. Modest discretionary actions to slow the growth of spending on statutory programs had been made in the May 1985 budget, which modified the indexation of the Family Allowance and slowed the growth of federal transfers to the provinces for health and education. Sufficient groundwork for reform of these and other statutory programs, such as Unemployment Insurance, federal pensions, or the Canada Assistance Plan, had not been completed prior to the February 1986 budget. The business community's pre-budget expectations that cuts would be made in these large areas of social spending were, therefore, quite unrealistic and unfortunate. The government cannot impose these reforms. Rather, they must be the outcome of extensive consultations with all Canadians about how to achieve the objectives of these widely supported programs in more efficient ways.

In the absence of a strategy based on such consultations, the government's only realistic alternative was to squeeze the growth of nonstatutory programs, which account for only 35 percent of total spending. This the government did -- by cutting planned spending by $500 million, or 2 percent. Additional restrictions were imposed on the growth of defense and foreign aid expenditures, but

these were offset somewhat by increased spending in a number of politically sensitive areas, including support of cultural activities, research and development, farmers, and unemployed older workers. Overall, the cuts will mean a nominal growth rate of 1 percent in nonstatutory spending, equivalent to a reduction in real spending of about 2.5 percent in fiscal 1987.

The cuts in nonstatutory spending could have a major impact on management of government. They require a fundamental change in the way federal departments are managed so that they, like the private sector, become more responsive to tighter budget constraints and more efficient allocation of scarce resources.

Because of the narrow set of options that existed for spending cuts this year, the remainder of the government's discretionary action to cut the deficit had to come from tax increases. The main political message of the February budget was that unless Canadians are prepared to reform statutory programs, they will have to pay more of the cost of these programs through higher taxes.

The Impact of Tax Changes

We accept the logic of this message. But we have two strategic concerns. The first is about the consequences of measures to raise taxes. The second is about the government's tendency to minimize the contribution higher taxes are making to deficit reduction.

The government had a number of revenue-raising alternatives, including increasing tax rates, widening the tax base, and reforming the tax structure in a way that increases revenues. It chose a combination of measures. Some widened the tax base -- by reducing personal tax expenditures, eliminating the inventory allowance, and phasing out the investment tax credit -- but the most significant proportion of new revenues was obtained by increasing the rates of federal sales and excise taxes and by introducing surtaxes on corporate and personal income.

The troubling aspect of this decision is that Canada is too closely integrated with the rest of the world for it to have tax rates at levels that are out of line with those of its trading partners. If they do get out of line, prospects in other countries become more attractive to people and to capital. Major tax reforms, which would lower personal and corporate tax rates, are under discussion in the United States. The debate is a tumultuous and chaotic one but if a compromise is reached, as many observers think it will be in 1986, there will be pressure on Canada to reverse the apparently permanent tax-rate increases on which the government is relying to meet its deficit-reduction targets.

To the surprise of many, the government took a first step in the budget toward reform of the corporate income tax. It also announced its clear intention to reform Canada's system of social expenditures and related tax provisions. We do not, therefore, regard that door as closed. Furthermore, the government indicated its intention to reform the federal sales tax. Again, such reform has to be accompanied by changes in personal income taxation. So that door is still open as well.

Our second strategic concern is the government's tendency to minimize the role that tax increases are playing in reducing the deficit. This approach has two consequences. First, it risks undermining the already shaky support of middle-income Canadians for getting on with the job of deficit reduction. Second, by downplaying the role of higher taxes, the government has missed an opportunity to build public support for a fundamental reform of personal taxes and transfer payments that could lead to a fairer, more efficient system with lower tax rates.

Post-Budget Issues

The government has prepared a credible fiscal plan that slows the accumulation of federal debt to the anticipated rate of growth of the economy by the end

of the decade. The accomplishment of this goal is based on important assumptions about anticipated economic performance, particularly oil prices and interest rates, that could have implications for the future conduct of monetary policy. In addition, the new fiscal plan is based on a structure of spending programs and taxation that is largely untouched by deficit-reduction decisions. If this structure is not reformed, its inherent distortions will interfere with the government's long-term growth strategy. If further deficit cuts are not to be made through higher tax rates, Canadians will have to reform statutory spending. If increases in tax rates announced on February 26 are to be replaced by a broader tax base, important steps will have to be taken to reform the personal income and sales taxes and to continue reforms begun in the corporate income tax. We see two very important post-budget issues: the conduct of monetary policy and the ability to live up to commitments made for further fiscal reform.

Monetary Policy

In the next few months, the budget's soundness will be tested by events in the international economic environment. If world oil prices remain for some months below U.S.$15 per barrel, Canada's economic prospects will have to be reduced somewhat. (At the time this **Commentary** went to press, spot market prices for crude oil were in the U.S.$12-13 per barrel range.) Investment, both by Canadians and by foreigners, in higher-cost oil exploration and development activities can be expected to drop until world oil prices rise once again.

The government gambled that financial markets would perceive the budget as a marked shift toward living within Canada's means. In taking this gamble, it assumed that most of the weakness in the dollar in early 1986 could be accounted for by speculators betting that the Bank of Canada would not move strongly in the dollar's defense with higher interest rates and direct intervention in foreign-exchange markets.

The dollar's persistent weakness in the days following the budget raised the question of fundamental, not speculative, sources of the depreciation. Capital-market effects of reduced government borrowing requirements plus reduced financing requirements for energy investment could depress the value of the dollar for some time, even without continuing speculation. If this happens, the monetary authorities face a dilemma. The Bank of Canada has argued that a weak dollar, which makes imports more expensive, is inflationary. This implies a preference for higher interest rates to support the dollar. At the same time, the budget assumptions indicated a preference for lower interest rates, both to hold down debt-service charges and to meet growth targets.

It follows, therefore, that if the dollar remains weak, depreciation should be resisted with means adequate to discourage speculation. But Canadian interest rates should not be held well above those of the United States for the purpose of protecting an exchange-rate target.

Because Canadians tend to become politically attached to particular threshold values of the Canadian-U.S. exchange rate, there is reason to be concerned about the possibility of a costly battle to defend the dollar from dropping below U.S.$0.70. The recent cut in the U.S. discount rate has reduced this risk for the time being, but U.S. interest rates could rise later in the year in response to faster economic growth and rising demand for credit. The Bank of Canada will have to follow a fine line between allowing the dollar to weaken and maintaining a sufficient spread in interest rates between the two countries to discourage destabilizing speculation.

Living up to Commitments

There is much unfinished business in the February 1986 budget. Following through on the government's commitments

will require both political will and a willingness by Canadians to consider major fiscal reforms. The fiscal policy debate in Canada in 1986 will be shaped by four main pledges contained in the budget:

- to hold the line on nonstatutory spending;
- to move ahead with reform of the corporate income tax;
- to reform the federal sales tax; and
- to initiate a comprehensive review of social spending and related tax provisions.

The first commitment -- to restrain nonstatutory spending -- though perceived as mild to some in the private sector, will reach a level not seen in Ottawa for decades. Nonstatutory spending is made up primarily of departmental budgets, including subsidies paid to Crown corporations and grants paid to companies, individuals, and other organizations in the private sector. The budget slowed the growth of spending on defense and official development assistance and included a $500 million reduction in other nonstatutory programs. These cuts are in addition to actions taken in the May 1985 budget, which eliminated automatic inflation allowances in departmental budgets, initiated a phased reduction in the size of the public service, and cut contingency reserves to meet unanticipated expenditure priorities during the course of the fiscal year. Taken together, these changes amount to a significant challenge to government managers. In order to stay within the government's overall expenditure targets, new priorities that arise in 1986 will have to be financed by reductions in departmental spending in other areas. Tough decisions on priorities will have to be faced.

Much of the fat now has been reduced from nonstatutory programs. The detailed studies of government spending conducted by the Nielsen Task Force on Program Review suggest that significant scope remains for budgetary savings through improved management within government. The Task Force recommendations may help government managers to cope with the cuts announced in the budget. But future cuts in nonstatutory programs probably will mean reduced services -- less new programming at the CBC, fewer services to farmers from the Department of Agriculture, increased crowding in federal penitentiaries, increased train fares or reduced service, and so on.

A second important commitment made in the budget was to take further steps to reform the corporate income tax. The first phase of reform included lowering corporate tax rates and broadening the base by phasing out the investment tax credit and eliminating the 3 percent inventory allowance. This is a useful step toward ending the erosion of the corporate tax base and the accompanying biases in investment decisions. Further measures will be required, however, to end the buildup of billions of dollars of unused tax deductions and credits and to ensure that the Canadian tax system remains internationally competitive.

Some analysts have argued that the government moved too quickly and without sufficient consultation, and that the changes will increase federal revenues -- contrary to the May 1985 proposal for a "revenue neutral" reform -- because the base-broadening measures are not fully offset by reduced basic corporate tax rates. Still another criticism is that the 3 percent corporate surtax will further increase the corporate tax burden. But part of the responsibility lies with Canada's corporate sector, which failed to take sufficiently seriously the May 1985 budget's discussion paper on corporate tax reform. The measures adopted in the February 1986 budget suggest that a phase two discussion paper to be released before mid-1986 will be the subject of a more active and meaningful debate.

The third commitment -- to reform the federal sales tax -- is one that involves high stakes for a large number of Canadians. The government announced in November 1985 that it was examining the possibility of replacing the existing archaic and inequitable manufacturers' sales tax with a value-added tax (VAT). Informal consultation on a VAT -- a sales

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tax levied on the value added at each stage of production for all goods and services -- has been going on for some time. Independent retailers have opposed a VAT because of its administrative burden. Economists and others have expressed concern that a VAT could represent for the government a potentially rich money machine that would allow it to avoid having to cut the deficit by increasing its spending efficiency.

In the February 1986 budget, the government indicated two changes that could increase the attractiveness to many of a VAT. First, a review is under way of alternative systems -- including a business transfer tax -- that involve less administrative burden. A business transfer tax is likely to turn out to be a VAT levied at each stage of production up to, but not including, the retail stage, thereby avoiding the resistance of independent retailers.

Second, the government has recognized that the new system could yield revenues sufficient to replace the existing federal sales tax, to end the 3 percent personal and corporate surtaxes, and to provide a sales tax credit to offset the regressive impact on low-income Canadians. The final decision on this reform must weigh the risk of such a tax merely financing the existing size and structure of public spending against that of its negative impact on the efficiency of the current sales tax, and the high marginal income tax rates that damage all Canadians' incentives to work, save, and invest.

The fourth commitment -- to conduct a review of social programs -- is also highly significant for all Canadians. Spending on social programs now accounts for nearly 60 percent of federal program spending. The February 1986 budget showed that significant expenditure control is impossible if social spending is declared off limits. But the May 1985 budget also showed that changes in social spending must be thought out carefully if they are to avoid stiff resistance -- not just from the recipients but from the majority of Canadians.

The government has promised to improve the structure of major social programs after reviewing the recommendations of the Macdonald Commission and the Forget Commission of Inquiry on Unemployment Insurance. The principles that will guide reform proposals include maintaining universal access, improving opportunities for individuals to become self-reliant, and shifting after-tax benefits toward those most in need and away from higher-income Canadians. The government has served notice that it will consider reforms that seek not just to reduce the deficit but to improve the effectiveness of the safety net.

Strengthening the net for those most in need will have a cost: reduced direct payments and higher tax-back rates for Canadians with incomes above the median level. But successful reforms could reduce future income security payments by improving the working of the labor market and by reducing the welfare dependency that plagues the current system.

The most important aspect of achieving these reforms will be the consultation process. Many Canadians continue to regard reducing the deficit as the government's problem. Finance Minister Wilson is now well out in front of the thinking represented by many interest groups. Consultation with such groups about choices for reform that also reduce the growth of costs will be essential. But the government must then decide what is in the national interest. In implementing its decisions, it will be well-advised to rely on those same interest groups to monitor the reforms to ensure that they meet specified objectives without adding to the burdens of disadvantaged Canadians.

These budget commitments involve two basic issues. First, while sticking to its deficit-reduction targets, the government will have to ensure that spending cuts are implemented in ways that continue to deliver high-quality services at lower cost. Unfortunately, anecdotal evidence suggests that publicly funded services are deteriorating -- in educational institutions, welfare services, and penal institutions, to mention a few. Dealing creatively with resource constraints will require more sophisticated and imaginative management of most publicly funded programs than has often been the case.

The second issue is to halt the negative impact on efficiency incentives from higher tax rates, by broadening the tax base instead. But since the sales tax reforms being considered could also become significant revenue raisers, careful planning will be required to ensure the real issue in deficit reduction -- reducing the role of the public sector in the economy -- is not obscured.

In conclusion, the February budget was a significant installment in a credible fiscal plan, but the next installment requires major structural changes in spending and taxation. There are grounds for skepticism that the government has the political will to follow through with what are likely to be very difficult changes in the third year of its mandate. But the Minister of Finance has proven the skeptics wrong before. If Canadians can be convinced that the deficit is their problem, as well as the government's, and if they can be persuaded to support the further changes that are essential, 1986 could be a significant year in securing Canada's long-term growth prospects.

Note: "Fiscal 1991" refers to the government's fiscal year, which ends on March 31 -- that is, the period from April 1, 1990, to March 31, 1991.